

**John D. Sullivan, Ph.D., Executive Director; Andrew Wilson, Deputy Director, Strategic Planning, and Regional Director, Eastern Europe and Eurasia; Anna Nadgrodkiewicz, Senior Program Officer, Global, Center for International Private Enterprise. The Role of Corporate Governance in Fighting Corruption. – 2013.**

Corruption is a corrosive drain on public trust and on the legitimacy of public and private sector institutions. Its toll can be devastating to a national economy, particularly at a time when open global markets can rapidly reverse investment and capital flows if confidence and trust are compromised by revelations of systemic corruption. Corruption affects all types and sizes of business firms — from global conglomerates to small and medium-sized enterprises (SMEs) and co-operatives — each with varying degrees of resources and capabilities to deal with the consequences. It has the power to destroy firms and with them, the livelihoods of stakeholders who depend on a company's success.

In Russia, as in many other countries, corruption remains a persistent problem. Despite Russia's accession to the World Trade Organization (WTO) in 2012 and heightened expectations of more transparency in business, corruption risks continue to pose a significant barrier to investment. In Transparency International's (TI) most recent Corruption Perceptions Index, Russia ranks 133<sup>rd</sup> out of 176 countries and territories surveyed with a low score of 28 on a scale where 0 indicates highly corrupt and 100 very clean.<sup>1</sup> According to Russia's Interior Ministry, the average size of a bribe remained stable between 2011 and 2012 at the ruble equivalent of US\$9,400<sup>2</sup> and the Prosecutor General recently estimated that damage from corruption in Russia exceeded 20 billion rubles (over US\$650 million) in 2012.<sup>3</sup>

In dealing with corruption, there are no simple answers. In some instances business can be a source of corruption, while in others it is simply a victim. Crucially, the private sector can be a force in developing solutions to the corruption problem, and companies around the world are taking charge. They are doing it in a multiplicity of ways. Some engage in collective action to reform the business climate to make it more transparent. Others push for ethical standards and fair practices in dealing with the government, as is the case with industry-initiated integrity pacts. Private sector solutions to corruption, however, are not only external in nature. Many companies are also beginning to look inside, seeking ways to ensure that they are not unwittingly contributing to the climate of corruption.

One key way of addressing corruption problem through internal measures is the establishment of strong corporate governance within companies. Good corporate governance is not only a tool that raises efficiency, improves access to capital, and ensures sustainability — it is also emerging as an effective anti-corruption tool. On the day-to-day transaction level it makes bribes more difficult to give and to conceal. At the

decision-making level, corporate governance injects transparency and accountability, so that it is very clear how decisions are made and why. Finally, underlying the very roots of corporate governance and providing its moral compass, is ethics.

The ethical behavior of companies is rarely recognized as a cornerstone of good corporate governance. Yet, in many ways, ethics underlies much of business behavior, whether it is at the board or staff level, and regardless of a company's geographic location, size, or industry. How business decisions are made matters from both an ethical and pragmatic standpoint not only in a large company from an Organisation for Economic Co-operation and Development (OECD) country doing business in its own back yard but also in a small business from a developing country engaged in regional trade.

In fact, legislation such as the U.S. Foreign Corrupt Practices Act (FCPA) or the United Kingdom Bribery Act places legal responsibility on large companies for the behavior of their suppliers and distributors in global value chains. Enforcement of these laws is creating pressure for companies to seek overseas business partners who share their commitment to anti-corruption. It also removes deniability of wrongdoing at the C-suite level when a local agent or supplier pays a bribe. Therefore, internal compliance becomes a key element of the board's approach to risk management.

External institutions shape the environment in which a company operates and they include contract enforcement, rule of law, and property rights. Internal institutions have to do with corporate governance and the rules it sets for how a company's strategy is formed and day-to-day decisions are made. In places where external institutions are weak, corporate governance and ethics play a much more fundamental role in facilitating repeat business transactions. As such, they are a key to economic growth and development.

### **The Challenge of Moving from Commitments to Compliance**

The principles underlying good corporate governance and business ethics are deeply rooted in universal values. The Universal Declaration of Human Rights has established a global consensus on the applicability of shared moral principles across various countries. Many of these principles that deal with individual rights such as right to property and equal treatment under the law are now reflected in landmark documents on ethical business behavior: OECD Anti-Bribery Convention; United Nations (UN) Convention against Corruption; World Economic Forum's Partnering Against Corruption Initiative; Transparency International's Business Principles for Countering Bribery; International Chamber of Commerce Rules of Conduct to Combat Extortion and Bribery; and the UN Global Compact's 10<sup>th</sup> Principle, among others. Growth of strong national anti-corruption legislation such as FCPA also affects the emerging global standards.

The challenge is to make sure that international and national commitments to anti-corruption as well as leadership calls for anti-bribery at the board level trickle down through the whole company to every last employee on the ground in countries around the world. Russia, for instance, recently joined the WTO and committed to a host of rules dedicated to open, fair, and undistorted competition. Among them are rules that aim to reshape the relationship between businesses and government away from favoritism (e.g., through the removal of quotas) toward greater transparency and impartiality (e.g., through the requirements to make publicly available all information on trade regulations and clearer criteria for regulations dealing with the safety and standards of products).<sup>4</sup> Such rules are meant to eliminate discrimination in trading and to reduce the scope for arbitrary decision-making by officials, and as such can greatly aid in fight against corruption. But will these rules translate into how business is conducted?

In the context of Russia's WTO accession, many firms and business associations are now making commitments to anti-corruption, seeking to become more competitive and attractive partners for trade and investment. Yet, the key question remains on how to make such commitments enforceable. After all, good corporate governance, ethics, and anti-corruption are not only about global conventions and statements — they are also about meaningful actions and the personal commitment to raise ethical standards. The corporate sector is replete with examples of firms that profess strong ethical cultures on paper but become unraveled by corrupt behavior.

TI's latest edition of the Bribe Payers Index, which examines the propensity of companies from 28 leading exporting countries to bribe abroad, places Russia at the very bottom of the list behind China.<sup>5</sup> At the same time, the pressure for change is mounting. In addition to WTO membership, in 2012 Russia also became a signatory to the OECD Anti-Bribery Convention that outlaws the bribery of foreign officials in international business transactions, reinforcing Russia's already existing domestic law that had made bribing a foreign public official illegal since May 2011.<sup>6</sup> It is unlikely that the practice will be eliminated overnight but Russian companies are now under increasing pressure not only to be "clean" at home but also to prevent "outsourcing" bribery and unethical behavior through complex international business networks used to conceal bribery.

Good corporate governance practices cannot be imposed by fiat, even if promulgated by the highest levels of leadership. Nor can corporate governance exist in a vacuum; firms will find it hard to comply with corporate governance regulations if there are no initiatives to improve the overall legal and regulatory climate in a country. Ethics and values (internally), and legal and regulatory institutions (externally), guide how corporate governance is developed and implemented. Corporate governance by itself should not be regarded as a panacea or an automatic cure for all corporate ills. However, if bolstered by

the values and behavior engendered in genuine ethical organizations with sound governance standards, corruption becomes the exception rather than the rule.

### **The Importance of Corporate Governance to Addressing Corruption**

TI's definition of corruption is succinct and yet comprehensive: "the abuse of entrusted power for private gain." Systemic corruption is by far the most damaging and the one that is most difficult to analyze and prescribe solutions. Its effects are well documented in the literature but it can still be too difficult to isolate the complex web of variables and factors that account for its damaging effects on undermining property rights; weakening the rule of law; limiting private sector growth; eliminating incentives to invest; debilitating institutional capacity; and delaying economic and political development.

Equally damaging to society is "state capture,"<sup>7</sup> particularly in the context of transition economies where companies make payments to government officials to shape legal and regulatory environments that help them create and maintain market control. On the other end of the spectrum is corporate raiding, a problem particularly widespread in Russia ("reiderstvo"), where state-connected companies manipulate the government's judiciary and taxation powers to expropriate private companies. In contrast with protection schemes or extortion, corporate raiding does not seek to gain just a portion of a company's profits but rather to take over the entire business through schemes involving corruption-tainted bankruptcy, litigation, or land and asset acquisition.<sup>8</sup> Such schemes often involve falsifying a target company's corporate documents, illicitly obtaining control over a significant portion of its shares, or using corrupt influence over the local judiciary to skew litigation outcomes and to authorize the seizure of assets.

The art of crafting preventive and punitive measures for corruption remains a central focus of reforms around the world. Preventive measures involve working through a country's legal framework and a society's moral norms to eliminate corruption incentives. Examples include the quality of procurement laws, business regulations, codes of conduct, freedom of information legislation, and independent oversight mechanisms. Punitive measures, on the other hand, are the post facto prosecution and application of specific sanctions to acts of corruption, with the intention to generate untenable costs that deter future corrupt behavior.

Where does corporate governance fit in this picture? As Sir Adrian Cadbury explained in the seminal 1992 *Report on Financial Aspects of Corporate Governance*, "Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their

stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

In order for an effective relationship to be maintained between the providers of capital and company managers, high levels of trust must exist between the two groups. For sufficient levels of trust to occur, four overarching corporate governance principles need to be in place:

- **Transparency:** Directors must make clear to the providers of capital and other key stakeholders why every material decision was made.
- **Accountability:** Directors should be held accountable for their decisions and account to shareholders by submitting themselves to appropriate scrutiny.
- **Fairness:** All shareholders should receive equal consideration by the directors and management with a sense of justice and avoidance of bias or vested interests.
- **Responsibility:** Directors should carry out their duties with honesty, probity, and integrity.

With corruption as an outcome of poor governance, the definition and practice of corporate governance is increasingly expanding beyond its traditional understanding of legal rights and obligations. In the 1999 *Corporate Governance Overview* report of the World Bank, Sir Adrian Cadbury further qualified his classic definition cited above: "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals...the aim is to align as nearly as possible the interests of individuals, corporations and society." As such corporate governance is crucial to anti-corruption and all other aspects of business operations.

### **The Business Case for Good Corporate Governance**

One does not have to rely solely on moral sensibilities to make the case that improving corporate governance is the right thing for a company to do. There is a business case for the benefits it brings to all types of companies. While traditionally associated with large, publicly listed corporations for which the main benefit of good governance is being able to raise outside capital through a stock exchange, corporate governance is much more broadly applicable. It can deliver benefits to other types of companies – including family owned firms, state-owned enterprises, and even SMEs – because it provides a framework for efficient, transparent, and accountable decision-making in every enterprise regardless of the size or form of ownership. Such benefits include a way of reconciling divergent interests, planning for strategy and succession, accessing capital, cultivating company image, and ensuring legal compliance.<sup>9</sup>

Corporate governance introduces internal controls that foster accountability and disclosure. Augmented with ethical codes of conduct and the leadership's tone from the top, proper corporate governance mechanisms are an important risk mitigation tool that can translate into palpable benefits. A study of S&P 500 firms by Deutsche Bank illustrated that firms with strong or improving corporate governance outperformed those with poor or deteriorating governance practices by about 19 percent over a two-year period.<sup>10</sup> Similarly, a study conducted by Harvard and Wharton researchers found that 1,500 U.S.-based firms with better governance had faster sales growth and were more profitable than their peers.<sup>11</sup> Good governance matters for stock returns and performance over time as well. Firms with weaker shareholder rights earn significantly lower returns, are valued lower, and have poorer operating performance.<sup>12</sup> Firms with better governance present less agency risk to shareholders, resulting in lower cost of equity capital.<sup>13</sup> And greater equity rates equal higher returns on investment relative to the cost of capital.<sup>14</sup>

Even in a poor investment environment of many emerging markets and developing economies, a well-governed company can do better than its competitors. An ABN AMRO study showed that Brazilian firms with above-average corporate governance had ROEs (returns on equity) that were 45 percent higher and net margins 76 percent higher than those with below-average governance practices. The study also showed that companies with the best corporate governance ratings achieved P/E (price-earnings) ratios that were 20 percent higher than firms with the worst governance ratings.<sup>15</sup> A study of the 100 largest emerging market companies by Credit Lyonnais Securities Asia showed that companies with the best corporate governance out of 495 companies examined in 25 global emerging market countries had eight percentage points higher measures of EVA (economic value added) than firms in their country average.<sup>16</sup> The study also ranked those markets for their overall framework of laws, regulations, transparency, and enforcement; Russia ranked at the very bottom of the list.

Research demonstrates that investors are willing to pay extra for well-governed companies. The Global Investor Opinion Survey conducted by McKinsey among more than 200 professional investors who collectively manage approximately US\$2 trillion in assets in 31 countries, including Russia, revealed that a significant majority of investors are willing to pay a premium for a well-governed company. These premiums averaged 12-14 percent in North America and Western Europe, 20-25 percent in Asia and Latin America, and over 30 percent in Eastern Europe and Africa.<sup>17</sup> Another study, focused specifically on 21 Russian firms, showed that a worst-to-best improvement in corporate governance predicted a whopping 700-fold increase in firm value. Such sizable returns may not hold equal magnitude if the study sample were larger but they still demonstrate a correlation between better governance and firm value.<sup>18</sup>

Similarly, two studies from the UK Institute of Business Ethics, based on a comparison of FTSE 250 companies, established a strong positive relationship between business ethics and financial performance. In comparing companies that demonstrated a commitment to business ethics with those that did not, and using the existence of a code of ethics as a proxy for such commitment, the 2003 study found that the companies with codes of ethics performed better against four different measures of financial performance: EVA, Market Value Added, stable P/E ratios, and Return on Capital Employed.<sup>19</sup> The 2007 study went a step further: companies that were implementing ethics training programs were compared with those that professed only a commitment to business ethics (the better performers from 2003 study). Consistent with the earlier results, companies that took steps to implement their declared ethical values financially outperformed those that did not go beyond a declaration of commitment to business ethics.<sup>20</sup>

On the flip side, the business world is filled with case studies of corporate collapses and severe financial losses stemming from weak or inexistent corporate ethical cultures and poor governance practices. Companies, like human beings, do not exercise consistent moral behavior. But with growing transparency and accountability in a globalized economy, well-governed, ethical organizations acquire sound business advantages in the international marketplace.

### **Corporate Ethics as a Culture of Doing Business**

The legal and regulatory framework within a national context sets the minimum standards of acceptable conduct in doing business, and reflects what society holds as fair and appropriate behavior by all types and sizes of firms. Thus, compliance with national laws is the starting point for doing the right thing by private sector organizations. Company executives, and the board of directors that provide oversight over management decisions, rely on internal policies, guidelines, regulations, and governance mechanisms to meet their compliance obligations. With increasing frequency, these governance systems transcend the minimum floor established by law and reflect the higher level of business ethics aspired to by companies.

Stringent requirements go a long way in creating robust checks and balances on inappropriate business behavior. However, a regulatory environment is never enough to safeguard against corruption. Ultimately, building an ethical organization has to do more with individual leadership and organizational commitment than about mere compliance with formal processes or systems. The exercise of such leadership is often referred to as “setting the tone at the top” and its significance applies equally to both internal and external stakeholders. As it is with trust, it takes long-term organizational efforts and investments to build a corporate ethical culture but it only takes a second of poor judgment or bad luck to undermine it beyond repair. Thus, any exceptions to the ethical standards and values that are internally promulgated will generate apathy and undermine

all efforts. Externally, any scandal, no matter how trivial it may appear, can instantly destroy the progress made through years of hard work and invested resources.

The best way to protect the ethical culture of an organization is to actively promote it, practice it, train in it, update it, and make it real and visible to external and internal stakeholders. In other words, the development of an ethical culture results from the continual and ongoing corporate commitment to integrate and align a company's ethical standards with business strategy and operations. In turn, such process is institutionalized through the implementation of a comprehensive ethics program whose various elements are elaborated further below. Managers, the board, and staff at all levels must exemplify through behavior and decisions the values and standards defined in an ethics program.

Senior executives have the paramount responsibility to embed ethical behavior into the culture of the company. By leadership, boards and CEOs can build an ethical organization and become the benchmark to be emulated by competitors, industry peers, and the private sector in general. Such visible commitment helps keep the organization on track to progress from just having a firm commitment to business ethics to creating an organizational culture where ethics is a central consideration in business decisions across all layers of a company. The perceived and observed behavior by senior management sets the tone throughout the company, it establishes the commitment and reputation of anticorruption initiatives, and it shapes the identity of the company.

By having in place a comprehensive ethics program that is aligned to its business strategy, a company can rely on institutional checks and balances that will help it make the right decisions when faced with challenging ethical dilemmas. To an ethical organization, ethics is about doing business right, not an issue of compliance. In practice this means that to uphold its ethical philosophy, at times a company must stand ready to lose business before compromising its values.

### **Business Ethics as an Operational Nexus Between Corporate Governance and Anti-corruption**

Business is often perceived as the cause of corruption. While this can certainly be the case, the business community is rarely thought of from another perspective — as a real victim of corruption and even less so as a solution. To control corruption in the private sector, a variety of legal and regulatory tools are often proposed — some more effective than others. While such tools are important in creating a climate where companies behave according to principles of transparency and fair competition, they nonetheless require another dimension for anti-corruption initiatives to be truly successful.

Given the new mandates on business growing out of the international standards of conduct as well as national legal frameworks and market expectations, firms find themselves pressed to develop strong codes of ethics to guide the behavior of board

members, managers, and employees. Multinational companies are also being required to set standards for those in their supply chains — in some cases setting higher standards than the laws of the countries in which they do business. There are many different factors that companies need to take into account when developing their own code of ethics as part of general corporate governance guidelines.

Laws and regulations of the countries in which companies operate as well as international conventions such as the OECD Principles of Corporate Governance are among such key factors. Many countries are beginning to require corporate governance codes as a condition of doing business. Another factor driving the development of corporate governance and business ethics codes is the notion of corporate social responsibility and corporate citizenship. Sustainability involves building a decision-making system that takes into account not only internal operating procedures, but also the impact of corporate behavior on its stakeholders — employees, investors, and communities.

A starting point to consider in developing initiatives to strengthen business ethics is the difference between bright lines and values. Bright lines are those standards that set out specific and very finite rules that companies and individuals cannot break. One such rule for instance is prohibition of bribery. Although bright line rules are often very specific, every individual company still needs to develop accountability practices to ensure that employees are indeed following these rules. To that end, guidelines such the *Business Principles for Countering Bribery*, spearheaded by Transparency International in cooperation with Social Accountability International, provide practical step-by-step approaches to help companies develop an entire internal practice to enforce anti-bribery.<sup>21</sup> Another example, discussed later in this article, comes from CIPE's work with the Thai Institute of Directors where nearly 100 companies voluntarily adopted a shared anti-corruption code of conduct verified by third-party audits.

Company size matters to how ethical standards can be effectively applied. Smaller firms obviously do not have the same resources in terms of staff, money, and time as multinational corporations have to ensure compliance. That is why there is no one-size-fit-all solution introducing both corporate governance standards and compliance mechanisms. Instead, solutions must be tailored to a company size and available time. Considerable progress has been made globally in that regard. Several countries have developed corporate governance codes for SMEs, family-owned companies, and state-owned enterprises. And the *Business Principles for Countering Bribery*, originally published in 2003, five years later added the SME edition.

Business associations also have an important role to play in advancing ethical standards among their members. For example, in December 2012 the leaders of Russia's four main national business associations signed a Russian Business Anti-Corruption Charter that is aimed at a global investment environment with rigorous compliance standards. The

Charter obliges its members to take concrete steps that include the prevention of bribing to foreign officials, the periodic audit of member businesses for compliance, and a robust expansion into Russia's regions. The Charter establishes a timeline for 2013 that includes publicizing foreign best practices and ramping up the number of businesses joining the effort. To date, 77 businesses have signed.

There are a number of other sources of ethical business beyond bright line rules. Historically, the Sullivan Principles have been among the most prominent documents on ethical business. These principles have been adapted and expanded by the United Nations Global Compact into its 10 principles that deal with the larger issue of values, including anti-corruption. Similar sets of principles were developed by the Caux Round Table and by the OECD (Guidelines Multinational Enterprises). The principles cited above, and others, go considerably beyond the bright line rules. In this sense, they translate ethics into a code to guide business behavior and decision-making, and they become standards that advance the global sustainability agenda.

### **Role of Boards of Directors**

As noted in the New York Stock Exchange listing requirements, it is very important for companies to develop their own ethics program. Simply adopting a code of ethics or a code of corporate governance with a companion code of ethics is not sufficient. This gives boards of directors a crucial role to play in defining and codifying a company's values and rules of conduct. A recent survey on business ethics and the role of boards, conducted among companies worldwide by the Conference Board (a global business membership and research association), is revealing. In the areas of design/revision, implementation, and oversight of ethics compliance, at least 10 percent of respondents indicated that the full board has responsibility.<sup>22</sup> This implies that many companies have taken steps to formally involve the entire board in their ethics programs compared to 2003 when in a similar survey by the Conference Board nearly all the boards of participating companies delegated program oversight responsibility to at least one committee.

In the United States – and increasingly internationally – this increased role of the board is closely connected to the developments such as the increase in FCPA prosecutions after 2007, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010, and the UK Bribery Act that went into effect in July 2011. Since the enactment of the 2004 Revised U.S. Federal Sentencing Guidelines applicable to corporate defendants, boards have taken on the additional responsibility of director ethics compliance and training to reduce liability risk. Under the Guidelines, a company that can demonstrate it had “effective compliance program” meant to prevent and detect criminal conduct can use that as defense if it is found in violation of FCPA.

A company that can demonstrate it had an effective compliance program is eligible for a reduced sentence by up to 95 percent of the statutory penalties. An “effective compliance program” is defined by 10 elements:

- The organization must have a written program standards and procedures to prevent and detect criminal conduct.
- The board of directors should be knowledgeable about the content and operation of the compliance and ethics program and exercise oversight.
- The company should assign the overall responsibility for the compliance and ethics program to one or more responsible persons from among high-level personnel.
- One or more individuals must be delegated day-to-day operational responsibility for the compliance and ethics program and they must report periodically to the management and the board.
- The company must use reasonable efforts not to hire or retain personnel with tainted record of compliance (due diligence).
- The company must undertake proper periodic communication and training on compliance standards and procedures and training.
- The company must ensure that its compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct, evaluating periodically the effectiveness of the program, and having a mechanism for employees and agents to anonymously report misconduct.
- The compliance and ethics program must be promoted and enforced consistently throughout the company through incentives and discipline.
- After criminal conduct has been detected, the company must take reasonable steps to respond appropriately and to prevent further similar criminal conduct.
- The company must periodically assess the risk of criminal conduct and take appropriate steps to design, implement, or modify its compliance program to reduce the risk.<sup>23</sup>

In November 2012, U.S. Department of Justice and the U.S. Securities and Exchange Commission released a comprehensive FCPA resource guide that further elaborated the hallmarks of effective compliance programs, starting with the commitment from senior management and a clearly articulated policy against corruption.<sup>24</sup> Similarly, the UK has recently released guidance to the Bribery Act about procedures that relevant commercial organizations can put into place to prevent persons associated with them from bribing. The guidance makes the board responsible for fostering “a culture within the organization in which bribery is never acceptable.”<sup>25</sup> It was accompanied by the Serious Fraud Office issuing joint guidance for prosecutors setting out the approach to deciding whether to bring a prosecution under the act.<sup>26</sup> Just like in the United States, a company can raise a

defense that it had adequate procedures in place to prevent the bribe in order to reduce the risk of severe sentencing in case a violation occurs despite its best efforts.

Even in countries where no equivalent laws have been enacted, companies are increasingly following a global trend where board-led actions put in place similar anti-corruption standards, procedures, ethics training programs for directors, employees, and increasingly also suppliers and distributors. The role of the board of directors, therefore, is seen as central to establishing and maintaining a corporate ethics program, and by corollary is a central feature in the overall subject of corporate governance guidelines and codes. This trend can be expected to continue, driven both by national legislation, international conventions, and the expectations of investors.<sup>27</sup>

### **Personal and Business Risks Stemming from Corruption**

For companies, the costs of corruption can be broadly summarized in two categories: personal risks and business risks. Given global trends and legislation such as FCPA and the UK Bribery Act, business risks extend beyond the company's own operations to the conduct of its suppliers and agents within cross-border value chains. These emerging norms also place greater personal responsibility for corruption on managers and directors who may be held responsible for behavior of their employees or business partners. Regardless of a country of origin or operation, corruption is illegal and by engaging in a corrupt behavior, even in countries with weak rule of law, individuals break the law and thus put their own future at risk.

In addition to criminal sanctions that individuals may face, they also have to deal with professional risk. Being implicated in corrupt transactions may ruin careers at all levels. Getting individuals to recognize the ramifications of corruption on the personal level is essential in ensuring that business measures to reduce corruption are actually followed through by all employees and are not discounted as directives that have little bearing in the day-to-day running of business operations.

For business, engaging in corruption or not putting adequate anti-corruption measures in place has several implications, including legal liability, reputation risk, increased costs of doing business, limited access to capital, and debarment from tenders. Making the case for “why” corruption should be addressed for companies from, and operating in, developed markets while important is not always necessary — they are already subject to domestic regulation, international conventions, ethical pressures, internal guidelines and structures, as well as long-term sustainability strategies that all put a greater emphasis on “how” corruption should be addressed. In many emerging markets, however, the “why” is still very important, as companies may feel that corrupt environments, poor governance, and bad regulations put them at the disadvantage if they do not pay bribes.

In weak rule of law environments where one can't rely on a legal system to ensure ethical behavior, there are few guarantees that other market players will behave ethically. Thus, while a company may attempt to follow the law and avoid paying bribes, it may not have the tools to ensure that others stick to similar practices. These pressures are magnified when competitors are not so much concerned with long-term development and are rather interested in the short-term extraction of government rents through bribery and favoritism. Solving this collective action problem is one of the key challenges in reducing private sector corruption in emerging markets. At the same time, global companies have the means and the power to shape the business climate where they operate. Best-practice companies can be proactive agents of change, simply by voluntarily agreeing to raise their standards of business ethics.<sup>28</sup>

Finally, another dimension to consider is the fact that corruption may take different forms. While bribery, for example, may denote a company's desire to sidestep regulations and secure a favorable deal, extortion on the part of government officials presents a whole different set of problems. Companies and individuals subject to extortion face a difficult dilemma, where on the one hand they are not actively seeking to pay bribes that are illegal, but on the other hand they may be forced to, especially if there are business or personal risks involved.

### **Corporate Codes of Ethics**

A code of ethics outlines the values and beliefs of an organization and ties them to its mission and objectives. The big question with any such code is how to enforce it. The danger rests in that members of an organization may develop a false sense of protection because they believe that the code of ethics absolves them from having to use personal discretion or individual judgment about what is right and wrong. Or if employees perceive a discrepancy between professed values and actual behavior, a code can be counterproductive and lead to apathy and mistrust, particularly if executive leaders and board members are seen to be exempt from the organization's ethical standards.

A good code not only describes an operational process and regulates the behavior of managers and employees, but it also sets long-term goals, communicates the company's values to the outside stakeholders, and motivates employees giving them pride in working for a company with clearly articulated, unequivocal values of conduct and operation. The value of a code of ethics is that it is more than simply a statement of a company's moral beliefs. A well-written code is a true commitment to responsible business practices in that it outlines specific procedures to handle ethical failures.

Originally seen as a set of policies designed to manage daily issues in the workplace, ethics codes have grown into extensive documents that address a variety of issues and serve as corporate complements to the regulatory and societal pressures on business to

behave in an ethical manner. A code of ethics, therefore, can imply high upfront costs in order to meet the expanded functions that it currently serves. For companies that must watch their bottom lines, such as SMEs, the costs of a code, especially if it requires the implementation of a comprehensive organizational ethics program, the initial investments may seem prohibitive in relation to short-term benefits. Over time, however, the initial cost may turn into positive investments for the company brand and reputation.

Codes of ethics exist to encourage ethical behavior and to take pride in making ethical decisions. Most importantly, employees at any level of an organization must strive to uphold the standards put forth by the code of ethics, and top management should exemplify those standards. The commitment and leadership of top management largely determines if the code of ethics becomes a powerful or an ineffective tool in support of an ethical organization, as codes are of little benefit if the leadership ignores them.

Lastly, the overall ethical performance of the company must be monitored and reported to stakeholders if it is to be credible to a wide audience of stakeholders, customers, and the general public. Both internal and independent external verification of the company's ethical culture is necessary to verify, detect, and make appropriate corrections when necessary. If ethical standards are not being met, company reports should disclose the steps being taken to remedy the situation and ensure that standards will be met.

### **Mainstreaming Ethics into Good Corporate Governance**

It is never too late to start building ethical organizations and initial steps are as important as those taken later to sustain the advanced systems that characterize the ethical culture of internationally recognized companies. The table below shows three levels of progression in building ethical organizations: starting from mere compliance, continuing to the systematic implementation of an integrated ethics program, and culminating with organizational leadership and innovations that set new standards and benchmarks of business ethics.

This table is by no means exhaustive of the possibilities open to organizations committed to good corporate governance and business ethics.<sup>29</sup> It is not meant to be prescriptive or to define a given set of progression levels; it simply illustrates the current spectrum of best practices by organizing it in a way that can be useful to a wide range of companies with varying levels of resources. Each company faces a unique set of contextual factors in which it operates, and it must adapt the existing best practice to fit with its own business strategy, corporate history, and appropriate level of organizational resources.

#### **Building an Ethical Culture – Every Step Counts**

**Level 1: Setting the Foundation — Complying with Legal and Regulatory Requirements**

- Designated ethics officer responsible for all reporting and disclosure requirements established by law and regulations
- Written code of ethics in place, adopted by Board of Directors
- Internal and external stakeholders consulted on company's ethical performance

**Level 2: Committed Engagement — Institutionalizing a Comprehensive Ethics Program**

- Commission external company ethics assessment to determine risks and opportunities
- Active engagement of internal and external stakeholders to determine company ethics program
- Ethics Program is an integrated and systematic application of key inter-related components:
  - *Ethics structure at Board level providing strategic leadership (Perhaps an Ethics Committee or Sub Committee)*
  - *Ethics Office, with appropriate level of designated staff and resources*
  - *Communications strategy tailored to internal and external stakeholders*
  - *Safe reporting lines for ethical misconduct (anonymous whistle-blowing hotline)*
  - *Ethics training program at all levels of organization and key external stakeholders*
  - *Internal monitoring and audit systems to report on effectiveness of ethics program components*
  - *Reporting and disclosure of ethical performance to external stakeholders*
- Certification of company ethics officers

**Level 3: Leading by Example — Setting New Ethical Standards**

- External independent verification of ethics program and assurance of performance
- Leader in initiating collective action solutions or forming coalitions to fight corruption

## **Successful Private Sector Approaches to Anti-Corruption**

### *Russia*

Russia's accession to the WTO heightened the government's interest in boosting investment and sparked interest by foreign firms considering entrance or expansion into the Russian market. Corruption remains a top reason for investors' wariness. As global standards for business ethics and compliance grow more relevant in Russia, firms doing business there are likely to have an increased awareness of the need to address corruption issues internally and to understand external corruption risks.

CIPE has worked with regional chambers of commerce in Russia for a decade now to identify key legal impediments to business and support the chambers in advocating for an improved regulatory environment. The scope of this work grew to include 17 regional coalitions that developed specific methodologies for targeting the institutional roots of corruption. Their work led to changes in local laws governing the auction of state property, starting a business, and the ways SMEs are taxed. The Saratov Chamber of Commerce and Industry, for instance, has developed methods and strategies that have influenced regulations adopted by federal ministries. Two examples are a 2009 law that allows business associations to review laws and regulations for their corruption potential and a 2012 program by the Ministry of Justice to measure legal implementation gaps.

In order to further leverage the substantial role of the private sector in combating corruption, CIPE is currently moving to strengthen private sector commitment to fighting corruption at the firm level. The effort will be focused in Russia's Special Economic Zones (SEZs) where firms enjoy lower taxes and customs duties and government officials are typically more aware of global business standards related to ethics and corruption and thus more likely to understand the value of anti-corruption efforts. What is more, SEZs attracted foreign firms with public commitments to fight corruption, including IKEA, Metro Cash and Carry, and General Motors. CIPE will work with its local partners in each area to devise and implement solutions to corruption, help local SMEs prioritize their legislative reform agenda, and help firms doing business in SEZs to understand common interests in fighting corruption on the firm level and through collective action.

### *Thailand*

Corruption has long been a serious issue in Thailand. However, until recently there were no initiatives that would reach beyond top-down government anti-corruption policies and public sector reforms such as anti-corruption regulations, tightening conflict of interest laws, or improving public procurement rules. Involving the private sector in such reforms was limited to new informational disclosure requirements for businesses, such as additional paperwork that must be submitted by tender participants. That changed in 2010 when CIPE and the Thai Institute of Directors (IOD) launched an innovative collective

action program demonstrating that businesses are not only interested in reducing corruption, but also willing and eager to take concrete steps to fight it.<sup>30</sup>

With assistance from CIPE, IOD has assembled a growing coalition of companies and business associations committed to fighting corruption. To join this coalition, a company signs IOD's Collective Action against Corruption Declaration – a document that lays out tangible and specific steps that a company must take to proactively reduce corruption-related risks on the part of its employees, managers, and vendors. Crucially, to remain a member of this coalition, a company must submit to an external evaluation of compliance. This private sector anti-corruption coalition includes the largest companies operating in Thailand, both Thai and multinational, along with the country's most influential business associations. CIPE and IOD estimate that this coalition represents over 15 percent of the entire Thai economy and more than one million employees.

Survey data gathered at the outset of this initiative revealed significant demand from the Thai business community for technical training on anti-corruption strategies. To meet this demand, and to help companies comply with the standards of this collective action coalition, CIPE and IOD developed a series of training programs for coalition companies and companies looking to join. IOD held six one-day workshops for corporate directors and executives over the past year, drawing rave reviews from participants.

To complement this course, IOD developed a separate two-day course to train corporate compliance officers and internal auditors on how to use a company's existing internal control structures to mitigate corruption risks. Participants also receive instruction on the certification process that a company must undergo in order to remain in the anti-corruption coalition. CIPE and IOD worked with PricewaterhouseCoopers and other prominent experts to develop new and unique technical content for this course, which is the first of its kind.

The fact that companies must make real commitments in terms of time and resources in order to join this coalition testifies to their dedication to fighting corruption. By establishing uniform standards of conduct to which companies must adhere and by facilitating the sharing of information on anti-corruption experiences and best practices, the Collective Action against Corruption campaign is leveling the playing field and increasing transparency and accountability in the Thai marketplace.

### *Pakistan*

CIPE has been working in Pakistan since 2006. That year, participants at a roundtable organized by CIPE in cooperation with the Pakistan Institute of Corporate Governance (PICG) and the Institute of Chartered Accountants of Pakistan (ICAP) recommended two

key reforms to be considered: a review of the 2002 Code of Corporate Governance and creation of a corporate governance guide for family-owned companies, which are common in the country.

CIPE Pakistan partnered with PICG and ICAP to develop the *Corporate Governance Guide for Family-Owned Companies*,<sup>31</sup> launched in 2008. Subsequently, CIPE conducted several workshops in cooperation with local chambers of commerce, which were attended by more than 500 members of family-owned companies. With the help of various family owned companies, CIPE Pakistan developed case studies on how family-owned enterprises can safeguard their legacy and longevity by following guiding principles of corporate governance.

With the assistance of CIPE and other partners, the revision of the 2002 Code of Corporate Governance is yet another breakthrough for the Securities and Exchange Commission of Pakistan (SECP) in keeping the country's corporate governance framework relevant, efficient, and effective. The process of revising the code involved several focus group meetings and three roundtables, as well as public comments solicited through SECP's website and follow-up meetings to finalize the code.

CIPE Pakistan also assisted the task force constituted by Economic Reform Unit of Ministry of Finance in October 2011. Public sector enterprise owners, the SECP, the PICG and the PBC (Pakistan Business Council) advocated for a viable governance structure for state-owned enterprises (SOEs) in Pakistan, which are direly in need of attention. A draft regulation has now been designed to address various governance challenges at SOEs. CIPE's work in Pakistan demonstrates that the government cannot act alone in promoting strong, ethical business norms. Companies must also place integrity at the forefront. By adopting a culture of self-improvement, both regulators and firms will benefit the economy in a long run.

### **Conclusion**

Anti-corruption attitudes have changed significantly over the past two decades. Corruption is no longer regarded as a subject to be avoided and is now widely condemned for its damaging effect on countries, industries, and the livelihoods of individual citizens. More importantly, the view of the private sector in the corruption equation is changing. Companies are no longer viewed only as facilitators of corruption — they are increasingly recognized as victims and a valuable source of working solutions, and anti-corruption efforts seen as integral to good corporate governance.

It has been an easier task to raise this awareness than to reduce the corrosive effects of corruption, especially its worst manifestation of state capture. And though the challenge defies simple solutions, significant progress is being made. Today we have in place

numerous international conventions and global collective action initiatives that set higher standards of transparency and accountability in corporate and public governance. More importantly, such standards are buttressed by a growing convergence of ethical values that set the tone for “doing the right thing” in both the public and private sectors.

For companies, the challenge of confronting corruption is complicated by the differences in the quality of institutions between countries. Businesses operating globally find themselves competing against companies and working with supply chains that have different governance structures, they face varying legal requirements and a diverse quality of law enforcement, as well as different views of corruption and approaches to combat it. This creates many problems for companies aiming to remain accountable and transparent in environments with weak rule of law.

A central mechanism accounting for the quality and sustainability of a free and fair business environment, as well as a proven effective anti-corruption tool, is corporate governance. Corporate governance not only sets up a system of institutions that govern the relationship between owners, investors, creditors, and managers, but also serves as a reform incentive towards global best practices of legal and regulatory frameworks. As an anti-corruption tool, it introduces standards and mechanisms of transparency, accountability, and compliance with laws and regulations, which over the long run exposes bribery and illegal behavior that makes corporate corruption unsustainable.

Underlying much of corporate governance is another key dimension — business ethics. Often viewed with skepticism, ethical behavior on the part of individuals, especially company leaders and decision makers, underlies much of what companies do and don't do in establishing good governance mechanisms and combating corruption. Ethics, in this regard, has to be thought of as a set of principles and values by which a company defines the very nature of its mission and operations, guiding the behavior of its board members, management, and employees at all staff levels. It is about leadership and organization-wide commitment to adapt and embody a company's ethical values in all decisions and operations, rather than to attempt to prescribe top-down rigid rules that will have no bearing on how a company functions on a day-to-day basis.

The fight against corruption starts at the top with clear commitment from leadership to the culture of integrity and the fundamentals of good corporate governance: fairness, accountability, transparency, and responsibility. Boards of directors, who are ultimately in charge of a company's overall strategy and conduct, must set the course accordingly. Yet, in order to be effective, the principles of corporate governance and business ethics need to be translated into daily operations and internalized by employees at all levels. Especially in companies with global operations, it is crucial that leadership calls for anti-bribery trickle down through the whole value chain.

What companies need now are the working solutions that build around the idea of ethics and tie together corporate governance reforms and anti-corruption initiatives. The private sector alone cannot build economic prosperity or national development that is crucial to poverty alleviation. It must continue and expand its engagement with governments and non-governmental organizations in developing solutions and reforming company level as well as country-level institutions. The triad of business, civil society, and governments will have to work together to devise and implement solutions that carry significant benefits for all.

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<sup>1</sup> 2012 Corruption Perceptions Index, Transparency International, <http://cpi.transparency.org/cpi2012/results/>

<sup>2</sup> Association of Russian Lawyers for Human Rights, “Corruption in Russia: Independent Annual Report of Russian Anti-Corruption Civil Society Center ‘Clean Hands,’” Moscow, 2012.

<sup>3</sup> “Damage from corruption in Russia exceeded 20 billion rubles in 2012,” Feb 20, 2013, <http://www.interfax.co.uk/russia-news/damage-from-corruption-in-russia-exceeded-20-billion-rubles-in-2012-chaika/>.

<sup>4</sup> WTO, “The 10 Benefits: 10. The System Encourages Good Government,” [http://www.wto.org/english/thewto\\_e/whatis\\_e/10ben\\_e/10b10\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/10ben_e/10b10_e.htm).

<sup>5</sup> <http://bpi.transparency.org/bpi2011/>

<sup>6</sup> “Russia joins OECD Anti-Bribery Convention,” February 17, 2012, <http://www.oecd.org/newsroom/russiajoinsocdanti-briberyconvention.htm>.

<sup>7</sup> Kaufmann, Daniel, Joel S. Hellman, and Geraint Jones. “Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition,” World Bank Policy Research Working Paper 2444, September 2000.

<sup>8</sup> Aaron Beitman, “The Challenge of Corporate Raiding in Russia,” Terrorism, Transnational Crime and Corruption Center, George Mason University School of Public Policy, Jan 3, 2013, <http://tracc.gmu.edu/2013/01/03/the-challenge-of-corporate-raiding-in-russia/>.

<sup>9</sup> Essays on Governance: 36 Critical Essays to Drive Shareholder Value and Business Growth, by Andrew J. Sherman. Advantage, 2012.

<sup>10</sup> Grandmont, Renato; Grant, Gavin; and Silva, Flavia. “Beyond the Numbers—Corporate Governance: Implications for Investors.” Deutsche Bank, April 1, 2004.

<sup>11</sup> Gompers, Paul; Ishii, Joy; and Metrick, Andrew. “Corporate Governance and Equity Prices.” *Quarterly Journal of Economics* 118(1), February 2003, 107-155, <http://fic.wharton.upenn.edu/fic/papers/02/0232.pdf>.

<sup>12</sup> Paul A. Gompers, Joy L. Ishii, Andrew Metrick, “Corporate Governance and Equity Prices,” NBER Working Paper No. 8449, August 2001, <http://www.nber.org/papers/w8449>.

<sup>13</sup> Skaife, Hollis Ashbaugh, Collins, Daniel W. and LaFond, Ryan, “Corporate Governance and the Cost of Equity Capital,” December 2004, <http://ssrn.com/abstract=639681>

<sup>14</sup> Data on returns come from Dennis Mueller, Klaus Peter Gugler, and Burcin Yurtoglu, “Corporate Governance and the Returns on Investment,” Working Paper 06/2003. European Corporate Governance Institute, Brussels (who in turn use data from Worldscope). The data on equity rights comes from Rafael La Porta, Florencio Lopez-deSilanes, Andrei Shleifer, and Robert Vishny, 1998. “Law and Finance.” *Journal of Political Economy* 106(6): 1113-55.

<sup>15</sup> Erbiste, Bruno. “Corporate Governance in Brazil: Is There a Link Between Corporate Governance and Financial Performance in the Brazilian Market?” ABN AMRO Asset Management, July 2005.

<sup>16</sup> “Saints & Sinners: Who’s Got Religion?” CLSA CG Watch, April 2001.

<sup>17</sup> “Global Investor Opinion Survey: Key Findings,” McKinsey & Company, July 2002, <http://ww1.mckinsey.com/client-service/organization-leadership/service/corp-governance/PDF/GlobalInvestorOpinionSurvey2002.pdf>.

<sup>18</sup> Black, Bernard. “The Corporate Governance Behavior and Market Value of Russian Firms.” *Emerging Markets Review*, vol. 2, March 2001.

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<sup>19</sup> Webley, Simon, and Elise More. 2003. Does Business Ethics Pay?. London: Institute of Business Ethics, (April).

<sup>20</sup> Ugoji, Kaodi, Nicole Dando, and Lance Moir. 2007. Does Ethics Pay? - Revisited. London: Institute of Business Ethics, (July).

<sup>21</sup> See: [http://www.transparency.org/whatwedo/tools/business\\_principles\\_for\\_countering\\_bribery](http://www.transparency.org/whatwedo/tools/business_principles_for_countering_bribery).

<sup>22</sup> Ronald E. Berenbeim, "Ethics Issues and Programs: The Role of the Board" (The Conference Board, New York, 2011).

<sup>23</sup> Richard L. Cassin, "Ten Elements of an Effective Compliance Program," FCPA Blog, Oct 22, 2007, <http://www.fcpablog.com/blog/2007/10/22/ten-elements-of-an-effective-compliance-program.html>.

<sup>24</sup> A Resource Guide to U.S. Foreign Corrupt Practices Act, <http://www.justice.gov/iso/opa/resources/29520121114101438198031.pdf>.

<sup>25</sup> The Bribery Act 2010 Guidance, <http://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf>.

<sup>26</sup> See: [http://www.sfo.gov.uk/media/65217/joint\\_guidance\\_on\\_corporate\\_prosecutions.pdf](http://www.sfo.gov.uk/media/65217/joint_guidance_on_corporate_prosecutions.pdf).

<sup>27</sup> See International Corporate Governance Network. <http://www.icgn.org>.

<sup>28</sup> Kaufmann, Daniel, Aart Kray, and Massimo Mastruzzi, "Governance Matters IV: Governance Indicators for 1996-2004," World Bank Policy Research Working Paper No. WPS 3630, 2005.

<sup>29</sup> The table draws upon and is consistent with the IFC Corporate Governance Progression Matrices for five types of companies ([www.ifc.org/ifcext/corporategovernance.nsf/Content/CG\\_Tools](http://www.ifc.org/ifcext/corporategovernance.nsf/Content/CG_Tools)). Also Willem Landman, CEO of the South Africa Ethics Institute, provided valuable inputs that are reflected in this figure.

<sup>30</sup> The program description is based on a CIPE article by John Morrell, "Business Shows Clear Commitment to Fighting Corruption in Thailand," February 1, 2013, [http://www.cipe.org/blog/2013/02/01/business-shows-clear-commitment-to-fighting-corruption-in-thailand/#.USqQ\\_XNet54](http://www.cipe.org/blog/2013/02/01/business-shows-clear-commitment-to-fighting-corruption-in-thailand/#.USqQ_XNet54).

<sup>31</sup> See: [http://www.cipe.org/sites/default/files/publication-docs/CG\\_Guide\\_Pakistan\\_08.pdf](http://www.cipe.org/sites/default/files/publication-docs/CG_Guide_Pakistan_08.pdf) and [http://www.cipe.org/sites/default/files/publication-docs/Safeguarding the Legacy Book.pdf](http://www.cipe.org/sites/default/files/publication-docs/Safeguarding_the_Legacy_Book.pdf).